MOSS ADAMS LLP
Certified Public Accountants | Business Consultants

Your Guide to Claiming the Federal R&D Tax Credit

Introduction

Over 100,000 US taxpayers claimed more than $12 billion in federal R&D tax credits in 2014 for work their companies performed on a day-to-day basis.

While there's no question that large, Fortune 500 companies account for a significant portion of the overall research performed and the credit dollars claimed each year, it's important to note that the R&D credit isn't limited to large companies with established R&D departments. In fact, Congress has taken action over the past five years to expand the amount of credits available to small and medium-sized companies and business owners.

There's no limit on the number of dollars available to US taxpayers that qualify for the R&D credit, and millions undoubtedly go unclaimed each year. Regardless of industry, any company that develops new or improved products, processes, or software could qualify under the US tax code.

Do You Qualify?

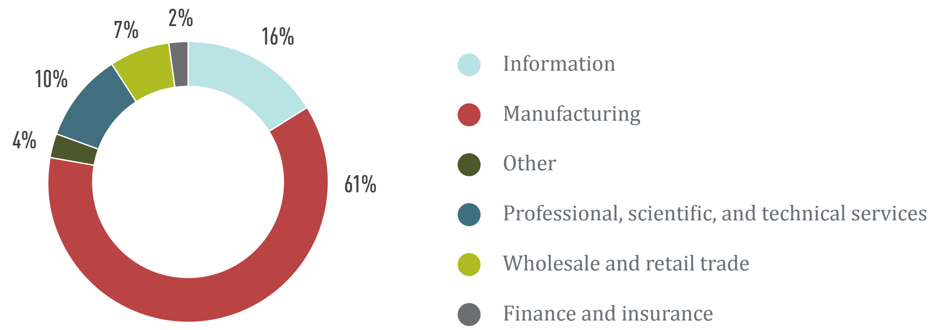
Regardless of industry, size, or revenue, any company that performs activities that meet the following four tests may qualify for R&D tax credits:

- **Technical uncertainty.** The activity is performed to eliminate technical uncertainty about the development or improvement of a product or process, which includes computer software, techniques, formulas, and inventions.
- **Process of experimentation.** The activities include some process of experimentation undertaken to eliminate or resolve a technical uncertainty. This process involves an evaluation of alternative solutions or approaches and is performed through modeling, simulation, systematic trial and error, or other methods.
- **Technological in nature.** The process of experimentation relies on the hard sciences, such as engineering, physics, chemistry, biology, or computer science.
- **Qualified purpose.** The purpose of the activity is to create a new or improved product or process (computer software included) that results in increased performance, function, reliability, or quality.

Companies can qualify for the R&D tax credit based on activities they already perform. Companies with potential R&D activities frequently:

- Develop processes, patents, formulas, techniques, prototypes, or software
- Improve or redesign existing products
- Hire scientists, designers, or engineers
- Devote time and resources to creating (manufacturing or developing) new or innovative products
- Develop patents, in other words, intellectual property

R&D Credits Claimed by Industry



Source: IRS Statistics of Income, "Corporations Claiming a Credit by Industrial Sector."
https://www.irs.gov/uac/SOI-Tax-Stats-Corporation-Research-Credit
Data as of 2012, the most recent data available from the IRS.

Regarding the data above, note that your typical R&D companies (professional, scientific, and technical services companies) make up only 10 percent of all credits claimed. This one-year snapshot also doesn't capture the fact that the number of R&D credit claims by construction companies is growing every year. Last, a number of industries roll up into manufacturing. In order of significance, these include:

- Computer and electronic product manufacturing
- Chemical manufacturing
- Machinery manufacturing
- Electrical equipment, appliance, and component manufacturing
- All other manufacturing

What Are the Benefits?

QUALIFYING EXPENSES

Amounts paid for salaries, supplies, contract research, and computer leasing could all qualify for the R&D tax credit.

Salaries paid to employees who conduct qualified activities are generally one of the largest components in an R&D credit claim, though this may not be true for pharmaceutical and construction companies, for example, whose most prominent expenses are often contract research. Money paid to the engineers performing qualified R&D activities—as well as first-line managers and personnel who directly support these engineers—can qualify.

A portion of payments made to US-based contractors as well as any supplies consumed in the R&D process are also eligible. Additionally, a portion of payments made to cloud service providers may qualify if they relate to qualified R&D activities, such as testing or development in the cloud as opposed to simple file storage or hosting for stable software releases. Note, however, that qualified supplies are rarely seen in companies claiming credits purely for software development activities.

DOLLAR-FOR-DOLLAR TAX CREDIT

Up to 9.1 percent of a company's annual eligible costs can be applied, dollar for dollar, against its federal income tax liability. Moreover, a majority of US states (36, in fact) has its own R&D credit programs. These come in varying incentive amounts, and many closely resemble or even mirror the federal rules regarding what types of activities and expenses are eligible. The R&D credit in some states is permanent.

CREDIT CARRYFORWARD

If you don't currently have a tax liability but your activities qualify, it's still important you document R&D expenses along the way. R&D costs incurred in years when a company has no income can be carried forward to offset tax on future profit. In most cases, any credits that can't be used immediately (due to losses, for example) will carry forward for up to 20 years.

RETROACTIVE CLAIMS

Federal taxpayers can also claim the R&D credit retroactively by filing amended returns for the past three tax years (or more if your company endured losses during that time). This makes it a good way to recoup tax previously paid. In addition, state taxpayers may also be able to amend returns that go back even further. For example, the California statute is open for four years.

Qualified Expenses

Does the activity qualify?	Does the expense qualify?	YES
• There's technical uncertainty. • There's a process of experimentation. • It's technological in nature. • It's conducted for a qualified purpose. • It isn't: > Research performed after commercial production* > Duplication (reverse engineering)* > Adaptation or custom-built component for a particular customer's requirements or needs* > Survey studies, market research, or routine data collection > Foreign research performed outside the United States (including US possessions) > Funded research > Research in the social sciences, arts, or humanities **If yes, then move to step two**	It's for qualified wages, supplies, contract research, or computer leasing. If wages: > They're W-2 taxable income. > They're paid to an employee who performs or directly supports or supervises qualifying activities. > They meet the "substantially all" test. If supplies: > They're either tangible personal property, extraordinary utilities, or computer or server leasing expenses. > They aren't capital items or general administrative supplies. If contract research: > It would qualify if performed by a direct employee. > It's performed under an agreement that puts the credit claimant at financial risk while granting it substantial (including shared) rights over the final product. > Generally, it isn't more than 65 percent of what's paid to the contractors. If computer leasing: > It's paid to a cloud service provider for hosting software under development (not for hosting a stable software release). **If yes, then move to step three**	It's a **qualified cost**. Up to 10 percent of total qualified costs can be claimed as a federal R&D tax credit.

* These activities can still qualify for the R&D tax credit if they otherwise meet the tenants of the four-part test.

Favorable Changes

Many companies aren't including all the expenses they're entitled to claim on their tax returns despite the fact that the landscape of R&D rules, IRS policy, and legal interpretations has led to a net increase in R&D-eligible activities in the past couple years.

PERMANENCE

On December 18, 2015, the federal R&D tax credit was made permanent by the Protecting Americans from Tax Hikes Act (the PATH Act), breaking from the previous pattern of annual year-end—and often retroactive—extensions. Businesses have long complained that the annual threat of extinction to the credit deterred them from pursuing critical research into new products and technologies. Thanks to the credit's now-permanent status, companies can factor a federal income tax reduction into their financial planning with more certainty.

ALTERNATIVE MINIMUM TAX

In addition to the permanent extension, beginning in 2016, eligible small businesses whose credits were previously limited by the alternative minimum tax (AMT) will now have the ability to utilize their credits.

Eligible small businesses are sole proprietorships, partnerships, and nonpublicly traded corporations with $50 million or less in average annual gross receipts for the prior three years. Generally, the amount of R&D credit taxpayers can claim in any given year is limited by the amount of tentative minimum tax they owe. However, the PATH Act permits eligible small businesses to use credits to fully offset their tax liability without regard to tentative minimum tax. Note that taxpayers with an income tax liability of more than $25,000 will still be subject to the 25/25 limitation—25 percent of the amount that exceeds $25,000—so they won't be able to take their tax liability all the way down to zero.

PAYROLL TAX

New or small businesses may be eligible to apply the R&D tax credit against their payroll tax for up to five years starting in 2016—an enhancement that came along with the credit's permanent extension under the PATH Act. The credit will also be able to offset alternative minimum tax. The credit is still based on credit-eligible R&D expenses, but offsets apply to only those costs incurred beginning in 2016.

The new payroll tax offset allows companies to receive a benefit for their research activities regardless of whether they're profitable. The new payroll tax offset is available only to companies that have:

- Gross receipts for five years or less—a company isn't eligible if it generated gross receipts prior to 2012
- Less than $5 million in gross receipts in 2016 and for each subsequent year the credit is elected
- Qualifying research activities and expenditures

The maximum benefit an eligible company is allowed to claim against payroll tax each year under the new law is $250,000.

Brand new businesses could potentially claim the credit for up to five years with a maximum of $1.25 million in total credits claimed on their quarterly payroll tax returns filed with the federal government.

The benefit will be between 6 percent and 14 percent of a company's eligible R&D costs. For the majority of new or small businesses that incur at least $300,000 in eligible R&D costs, the federal credit to offset payroll tax will be equal to 10 percent of their total R&D expenses.

For example, a company with $500,000 of eligible expenses—let's say engineering costs—could have a credit of $50,000, while a company with over $2.5 million in eligible expenses in 2016 could have a credit subject to the full $250,000 annual limitation. If the amount of the credit exceeds a company's social security tax (OASDI tax) liability in any given quarter, the excess will be carried forward to the next calendar quarter.

ALTERNATIVE SIMPLIFIED METHOD

Rules published February 27, 2014, allow companies to go back and claim R&D credits on amended returns under the alternative simplified credit (ASC) method for all open tax years. This is good news for organizations that previously missed out on claiming the R&D tax credit because of a lack of substantiation in the base years.

In the past, IRS regulations specified that a taxpayer making an ASC election had to do so by attaching Form 6765, Credit for Increasing Research Activities, to an original return for the year to which it applied. Many tax practitioners argued that the burden of substantiating expenditures and costs for the base period, which require a taxpayer to substantiate activities as far back as 1984 under the regular credit, can be difficult and time-consuming. As a result, some taxpayers passed on claiming an R&D credit altogether.

The new rules ease this burden. However, they stipulate that a taxpayer may not make an ASC election for a tax year on an amended return if it already claimed a credit for that tax year using the traditional method. Permitting such a change could have resulted in more than one audit of a taxpayer's research credit for a tax year.

The rules, encapsulated in revisions made to the regulations of Section 41 of the Internal Revenue Code, also limit the availability of the ASC method via an amended return to members of a controlled group. In a given tax year, if any member of a controlled group claimed the R&D tax credit using a method *other than* the ASC method on its original return, no other taxpayer in the controlled group can claim the credit using the ASC method on an amended return for that year.

R&D EXPENDITURES

As a result of IRS regulations issued on July 21, 2014, businesses may, in certain cases, benefit from expanded opportunities to deduct or amortize some of the costs of developing or building a product or piece of equipment.

No Distinction Between a New Product's Failure or Success

If your business expends resources to build a prototype or pilot model and those expenditures meet the IRS's R&D criteria, they qualify under Section 174 regardless of the prototype's outcome or final use. In other words, the expenses are eligible for the R&D credit regardless of whether the prototype succeeds or fails or whether you end up using it in your business or selling it to external customers.

Here's an example of this type of Section 174 qualification, per the final 2014 regulations: Say a food and beverage business designs a specialized piece of equipment for improving its bottling process. In an effort to remove uncertainty and evaluate different designs, the company develops a working pilot model at a cost of $1 million. Whether the company later sells that prototype or uses it as a demo model in its business, the $1 million in incurred costs qualify as R&D expenditures. Therefore, they could be eligible for deduction under Section 174.

Depreciable Property Costs May Be Eligible

Under the depreciable property rule, expenditures for the acquisition or improvement of property subject to an allowance for depreciation or depletion aren't deductible under Section 174. However, depreciation deductions can qualify as Section 174 expenditures to the extent the depreciated property is used in connection with research and experimentation.

The final regulations clarify that the depreciable property rule is an application of the general definition of *research or experimental expenditures* and shouldn't be applied to exclude otherwise eligible expenditures.

Component Parts

If you incur qualifying R&D costs to add a new component to an existing product, the costs associated with that particular component may qualify under Section 174—but not the costs associated with the original product.

The final 2014 regulations preserve Section 174 eligibility for certain component R&D costs even though the entire product may not be new. The IRS now refers to this as the "application of Section 174 to components of a product." It was previously referred to as the shrinking-back rule.

For example, say you manufacture aircraft engines. You research and develop a new type of blade to improve an engine's performance, and to test the new blade's design, you produce the blade and install it on one of your existing engine designs. Because the blade design is new and you incurred R&D costs to resolve uncertainty about its function, it's considered a pilot model under Section 174 and is eligible for deduction. However, the costs of producing the engine (in which you tested the blade) aren't eligible, since uncertainty had already been removed from its development.

INTERNAL-USE SOFTWARE (IUS)

Final regulations released on October 4, 2016, clarify what is and isn't IUS.

Under these regulations, IUS development is subject to additional eligibility rules, referred to as the "higher threshold of innovation" tests, which go beyond the rules for non-IUS R&D activities. Because the final regulations expand and clarify the definition of IUS, they open the door for more software development activities to potentially qualify for the credit.

What Software Is Eligible?

To illustrate what types of software are now eligible to claim the credit without meeting the higher threshold-of-innovation requirements, the regulations use the example of an e-commerce Web site. In the past, the software that allows the site to manage orders and process transactions may have been subject to the IUS requirements, since it isn't licensed or sold to its users. Now, because the software users receive the benefit of that technology despite their not having purchased it, the software may not be considered IUS. Therefore, the activities involved in creating it wouldn't be subject to the higher threshold-of-innovation requirements.

Though software development was always intended to be eligible for the R&D tax credit, it has traditionally been subject to more controversy than many other R&D activities. This is evident in the number of related court cases over the last decade and the complexity of the IUS rules, which have been included in the IRS's priority guidance plan for the last few years. Since the eligibility rules were first defined in the 1980s, software development has advanced in new directions, and the regulations have been slow to adapt. As a result, these changes should come as a welcome change for developers and others who perform software development in support of their other operations.

Your Next Steps

DOCUMENTATION IS KEY

If you think you might claim the R&D tax credit now or in the future, start by documenting potential projects, namely products or processes, that may qualify. Evaluate all your company's activities for potential eligibility, then begin tracking qualifying expenses and gathering documentation to support the costs.

This will save you time and strengthen your claim if and when you decide to pursue the credit. It's worth the effort to get a process in place now, even if you're not in a position to take the credits immediately. Employees leave, memories fade, and documentation is lost with time—which means if you don't document your expenses now, you may lose the ability to claim them in future years.

And there's yet another reason that documenting projects and expenses is important: Tax credits can attract investors and boost your company's value should you decide to sell in the future, because the credits may be passed on to the new owners. Note, however, that Section 382 limits the availability of R&D tax credits to an acquirer, so examine the specifics of your situation closely before making a decision about R&D credits based on that possibility.

To start, collect documents that:

- **Substantiate amounts**, including financial, tax, and payroll records
- **Provide nexus** between the amount and the activities performed, such as project accounting or time-tracking records
- Identify and **demonstrate qualified nature of activities**, such as development reports, patents, testing documentation

Documentation examples can also include employee time tracked to projects and time survey estimates based on contemporaneous documentation. Contemporaneous documentation can include project development notes, test reports, project designs, e-mail communications, and mock-ups or models. For software development projects, it can also include information extracted from project management tools or code repositories that help demonstrate an iterative process of experimentation.

DOCUMENTATION TIPS

Retain notes, design revisions, and other support related to potentially qualifying projects in one place. By carefully separating expenses into those that may qualify for the R&D tax credit, companies can claim a lucrative opportunity as well as improve their financial position and clear the way for ongoing research.

Isolate and track expenses related to potential R&D activities in a manner that works for your business and accounting system. Many companies don't keep their books and records organized in the manner an IRS or state auditor will request. Engineers often don't want to be bothered with project time tracking or documentation of their qualifying work, but it's important to encourage these activities. For many companies, examination teams often focus on nexus—the connection between qualified research expenses and activities. Keeping books and records organized may not be on the top of your engineers' to-do lists (or yours) today, but it could pay to spend some time evaluating your R&D activities and costs and, more specifically, the documentation you have to support them.

Give due attention to contract agreements. For companies that conduct research under agreements with customers or subcontractors, the IRS and state authorities are likely to request your contracts. That's to verify that your company bears the financial risk of those contracts—a necessary condition for R&D credit eligibility—and retains rights to any intellectual property developed.

Be particularly cautious if you plan to carry credits forward. Companies on the verge of profitability (or that have plans to sell or go public) may be particularly vulnerable to examination if they've claimed credits on their tax returns to carry forward and use later. Oftentimes companies in this situation haven't yet prepared the documentation they'll need when they start actively using the credits, and credits are typically scrutinized more closely once they're actually used to offset income tax.

In today's world of rapid technological development and change, R&D-qualifying activities are pervasive. As a result, companies need to stay on top of where they're investing valuable resources so they don't miss out on the credits available to them. Those savings are critical to fueling further innovation; in fact, studies show that 70 percent of credit dollars are used to pay the salaries of highly skilled engineers and to increase investment in R&D.

SEEK PROFESSIONAL ADVICE

The R&D tax credit is a valuable opportunity to increase your cash flow. Still, it shouldn't come as a surprise that claiming the R&D tax credit and documenting your expenses can be complex.

Leveraging federal and state R&D tax incentives requires an understanding of IRS documentation requirements along with a technical understanding of the products and processes being put forward for credit claims. Further, the rules surrounding tax incentives keep changing, and many companies lack the resources to determine which of their activities could enable them to take advantage of the credits and current deductions.

Finally, determining the true cost of R&D is often made even more difficult by the fact that few companies have project accounting systems that capture the cost of support provided by the various personnel who collaborate on R&D. Typical project tracking systems don't include contractor fees, direct support costs, or the salaries of high-level personnel who participate in any given research effort. Most project accounting systems also aren't designed to track time or expenses to the specific activities or subcomponents of a project.

For these reasons, companies interested in claiming the R&D tax credit frequently work with an R&D credit services provider.

Typical R&D Service Provider Process

PHASE 1	PHASE 2	PHASE 3
Determine credit and fee range for engagement.	Perform fieldwork to gather support and documentation for credit claim.	• Deliver report summarizing methodology, cost analysis, and other documentation. • Create processes to better substantiate the credit going forward.

Before working with a tax credit service provider, ask yourself whether that provider has:

- Sufficient experience performing R&D credit studies and a good reputation
- Tax-experienced CPAs on staff who focus primarily on the R&D credit and its benefit to each shareholder
- Made a commitment to you to follow through and stand behind the R&D claim in the event of an IRS or state exam and any subsequent appeals
- A documented approach that includes spending time interviewing you and your staff
- A fixed fee (in accordance with Circular 230) or is trying to circumvent compliance by charging a percentage of the credits calculated

The Fee Structure Matters

With regard to the fee structure, spend time understanding how your R&D tax services provider proposes to charge you for its services and what the impact of such an arrangement would be. Circular 230, the set of IRS rules that govern what CPAs, attorneys, and other providers of tax advice must (and must not) do, prohibits tax preparers from performing R&D tax credit engagements under a contingency fee arrangement.

To get around this, some providers cap their fee based on calculated (anticipated) credits rather than actual credits received. The hourly rates associated with this fee structure are generally high when compared with those of other providers. The result is less work performed at a higher cost per hour. Even though this fee structure may provide IRS examination support once the cap is reached, no amount of the fee will be refunded to you if the credit is disallowed by the IRS during examination or is otherwise unusable.

By contrast, many firms will provide R&D tax credit services on an hourly or fixed-fee basis. This cost structure generally involves the provider creating a specific project plan customized to your individual needs. The total fees are generally lower than those based on a percentage of the credit. If your company is selected for IRS examination, exam support is generally also charged on a fixed-fee or hourly basis. However, exam costs can be negotiated as part of the R&D service engagement.

Whatever the fee structure, it's always important to secure hourly rates and a proposed scope from your service providers before selecting one.

Conclusion

If you think your company might be performing work that qualifies for the R&D tax credit, don't let the potential tax savings go unclaimed—and don't be intimidated by preconceived notions of what R&D is or what companies can qualify. Across industries, the possibilities for qualifying activities are out there, and if you're willing to take a look, you could uncover vital tax savings to reinvest in your business and fuel your next big project.

To learn more about the credit and how much you might save, contact our R&D Tax Services professionals at creditsandincentives@mossadams.com or (800) 929-3693. You can also become a part of the conversation and stay up to date on R&D-related news by joining our R&D Tax Credits Forum on LinkedIn.

Special thanks to Travis Riley for sharing his insight and undertaking additional research to compile this white paper. Travis has provided research tax credit studies to companies claiming R&D credits since 2006. He's a leader in the firm's R&D Tax Services group in California, helping both companies and business owners save millions of dollars in taxes each year.